IN THE

Supreme Court of the United States

October Term, 1952

No. 290

ERNEST A. WATSON and M. GLADYS WATSON,
Petitioners

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF AMICUS CURIAE

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BRIEF OF AMICUS CURIAE

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The undersigned herewith respectfully file with this Honorable Court this brief as amicus curiae. The petitioners' written consent to such filing is filed herewith; and respondent's written consent has been previously filed with the Clerk of the Supreme Court under date of December 30, 1952.

Preliminary Statement—
Interest as Amicus Curiae

The issues raised in this cause are of concern to various parties represented by the undersigned by virtue of causes presently in litigation in the Tax Court of the United States(1), and like matters presently involved in pre-litigation stages with the Internal Revenue Service. The instant cause involves the great citrus fruit growing industry of the State of California; and certiorari was granted, we presume, largely because of a conflict of decisions in the Courts of Appeals, decisions contrary to that of the Ninth Circuit in the instant case

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(1)

Ann Edwards Trust, L. C. Edwards, Jr., Trustee, vs. Commissioner of Internal Revenue, Docket No. 25471;

Nancy Edwards Trust, L. C. Edwards, Jr., Trustee, vs. Commissioner of Internal Revenue, Docket No. 25472;

W. F. Edwards vs. Commissioner of Internal Revenue, Docket No. 30884;

L. C. Edwards, Jr., vs. Commissioner of Internal Revenue, Docket No. 30885.

Other cases, which have been considered by the respondent to be related (contrary to our view) are:

Triple E. Development Company vs. Commissioner of Internal Revenue, Docket No. 26008;

Louise H. Edwards vs. Commissioner of Internal Revenue, Docket No. 24909;

Triple E Development Company vs. Commissioner of Internal Revenue, Docket No. 24910;

W. F. Edwards vs. Commissioner of Internal Revenue, Docket No. 24911;

Katherine T. Edwards vs. Commissioner of Internal Revenue, Docket No. 24912;

L. C. Edwards, Jr., vs. Commissioner of Internal Revenue, Docket No. 24913;

M. E. Price vs. Commissioner of Internal Revenue, Docket No. 24914.

having been previously rendered by the Court of Appeals for the Tenth Circuit, and the Court of Appeals for our own Circuit, the Fifth. This latter concerned the great citrus growing industry of the State of Florida, and we thus have the exact counterparts in opposition before this Court.

Frankly we see no essential difference which would distinguish the instant case from those which were the basis of contrary decisions, and certainly we do not apprehend that petitioners' counsel will not vigorously and thoroughly present to this Court all facets of the case in brief and argument. We do feel that it is in the best interests of our clients and of aid to this Court to try to present an analysis by local counsel of the decisions of our courts in the Fifth Circuit which are opposed to the decision of the Ninth Circuit in the instant case.

Statement of the Question Involved

At the risk of being incautiously brief, we believe the proposition before this Court for solution is a very simple one.

Facts. The owner of a citrus grove has operated it in his business, which was the production and sale of *ripe* fruit, and has held the grove for more than six months. He then sells it—including in the sale the unmarketable immature citrus fruit then growing on the trees—for a single lump-sum consideration.

Problem. Is the immature citrus fruit on the trees at the time of sale a part of the realty sold and

"not held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"? If it is, it is entitled to capital gains treatment under §117(j) of the Internal Revenue Code.

Statute Involved

The pertinent parts of §117(j) of the Internal Revenue Code are these:

(j) Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) Definition of property used in the trade or business.—

For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business * * *

(2) General Rule. — If during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, * * * exceed the recognized losses from such sales or exchanges * * * such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets." * * *

Outline of Argument

I. Under Section 117(j), growing citrus fruits are "real estate" until actually or constructively severed.

A. As the Internal Revenue Code does not define real property, the status of the fruit as realty or personalty is to be determined by local law.

Owen vs. Commissioner, 192 F. 2d 1006.

B. Under both California and Florida law, crops of fruit growing on the trees, whether mature or immature, are in general a part of the realty until actually or constructively severed.

Owen vs. Commissioner, 192 F. 2d 1006

Adams vs. Adams, 158 Fla. 173, 28 So. 2d 254

Wilson vs. White, 161 Cal. 453, 119 Pac. 895

Sweet vs. Watson's Nursery, 92 P. 2d 812

Watson vs. Commissioner, 197 F. 2d 56, 57

C. If there were a federal common law applicable, the result would be the same.

1. No federal general common law.

Erie R. Co. vs. Tompkins, 304 U. S. 64, 78.

Western Union Telegraph Co. vs. Call Publishing Co., 181 U. S. 92, 101.

2. Ungathered crops are part of the realty.

Viterbo vs. Friedlander, 120 U. S. 707, 730.

II. Under Section 117 (j), unsevered citrus fruits which are disposed of as part and parcel of the sale of the land and trees, are "not . . . property held by the taxpayer primarily for sale to *customers* in the *ordinary* course of *his* trade or business."

A. The terms "capital assets" and "property used in trade or business" are to be broadly construed.

Homer Hendricks, *Federal Income Tax: Capital Gains and Losses*, 49 Harv. Law Rev. 262, 263.

Thomas E. Wood, 16 TC 213, 219-220.

B. If the property sold is realty, and the taxpayer does not sell realty, nor hold it for sale to customers in the ordinary course of his trade or business, its sale is not within the exception in section 117 (j).

Owen vs. Commissioner, 192 F. 2d 1006

McCoy vs. Commissioner, 192 F. 2d 486

Irrgang vs. Fahs, 94 Fed. Supp. 206

C. It is the property which is *sold*, at the *time* it sold, and not what it potentially might become, that is classified in accordance with section 117 (j).

Owen vs. Commissioner, 192 F. 2d. 1006

McCoy vs. Commissioner, 192 F. 2d 486

Irrgang vs. Fahs, 94 Fed. Supp. 206

United States vs. Bennett, 186 F. 2d 407

Argument

As these cases have sifted through the courts it has appeared that respondent's contentions have been limited to the two to which we referred above:

1. The immature citrus fruit growing on the trees is not a part of real property, and

2. That even if real property, these growing crops are nevertheless property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

We believe that these contentions are contrary to a proper construction of §117(j) of the Internal Revenue Code, that immature citrus fruits growing on the trees are real property; and that, furthermore, they are not property held by taxpayers involved primarily for sale to customers in the ordinary course of their trade or business.

I. Under Section 117(j), growing citrus fruits are "real property" until actually or constructively severed.

When the taxing statute uses words of local or common law significance, without definition, it seems plain that it was the intention of Congress to have the local law determine the property rights which were to be taxed, leaving the manner of taxation to Federal law. The Court of Appeals for the Fifth Circuit so held in *Owen vs. Commissioner*, 192 F. 2d 1006, 1008:

> "As the Internal Revenue Code does not define real property, the status of the fruit as realty or personalty is to be determined by the law of Florida."

This court, and other Federal courts, have applied the same principle in similar situations, *Magruder vs. Supplee,* 316 U. S. 394, 396; 86 L. ed. 1555, 1558; *National Memorial Park vs. Commissioner of Internal Revenue,* 145 F. 2d 1008, 1014 (CA, 4) cert. denied, 324 U. S. 858, 89 L. ed. 1416.

Under both California and Florida law it is settled that crops of fruit, whether mature or immature, which are growing on the trees are a part of the realty unless actually or constructively severed. The decision of the Court of Appeals in the instant case apparently does not quarrel with this proposition, and assumes, arguendo, that it is correct. *Watson vs. Commissioner,* 197 F. 2d 56, 57. When dealing with the transaction here involved, the sale of an orange grove, there seems to be no doubt that the Supreme Court of California would determine under its decisions that the crop constitutes a part of the realty, absent a constructive severance. *Wilson vs. White,* 161 Cal. 453, 119 Pac. 895.

The Court of Appeals for the Fifth Circuit very firmly stated the effect of the Florida law:

> "The Florida rule is that crops of fruit growing on trees, whether mature or immature, are in general a part of the realty until severed."
>
> *Owen vs. Commissioner,* 192 F. 2d 1006, 1008.

This case and *Irrgang vs. Fahs,* 94 Fed. Supp. 206, decided in the United States District Court for the Southern District of Florida in 1950, both rely for this proposition on the latest decision of the Supreme Court of Florida, *Adams vs. Adams,* 158 Fla. 173, 28 So. 2d 254, 255, where the court said:

"* * * Crops unseparated from the tree or vine are a part of the real estate till separated and follow the latter unless in terms reserved by the seller. We find some exception to this rule, but it is the one generally approved throughout the country."

It is obvious that any appendage to the real property may be actually or constructively severed from it, and as such become in the nature of personalty. This is not a situation unique to growing crops. As a matter of fact, under some circumstances the trees themselves might be actually or constructively severed, either as crops or timber. The case of *Sweet vs. Watson's Nursery,* 92 Pac. 2d 812, 815, dealt with orange trees in their nursery or pre-production stage, and there applied all the usual rules concerning growing crops.

Were there a Federal common law applicable under which a definition of real estate could be obtained, the result would be the same. It has generally been stated, of course, that there is no Federal general common law. *Erie R. Co. vs. Tompkins,* 304 U. S. 64, 78; 82 L. ed. 1188, 1194; *Western Union Telegraph Co. vs. Call Publishing Co.,* 181 U. S. 92, 101; 45 L. ed. 765. To the extent that it is necessary to a construction of Federal statutes it is sometimes assumed that there is. *McNally vs. Hill,* 293 U. S. 131, 136; 79 L. ed. 241. If this were so, the only pronouncement on this subject which we are aware this court has made is in *Viterbo vs. Friedlander,* 120 U. S. 707, 730; 30 L. ed. 784, where this court said in a case involving the civil law:

"There is no doubt that by the civil law, as by the common law, crops so long as they are standing and ungathered are part of the land to which they are attached."

As stated in *McCoy vs. Commissioner,* 192 F. 2d 486, 487, (CA, 10), this is the "general rule"; and, as that decision states—

> ". . . there is logic and reason behind this. Growing crops depend for their life upon the real estate of which they are a part. They draw their food and sustenance therefrom. Separate them from the real estate and they cease to exist and die. Except as a part of the real estate, a growing immature crop has no value."
> (at page 488)

That logic is sound, not only to demonstrate that there is reason in the rule which considers growing crops as real estate, but to demonstrate that as growing crops, they are distinctly different from the ultimate product which the grove owner later severs and holds for sale, and on the sale of the grovelands must be classified as an inseparable part of the assets which under §117(j) are subject to taxation on a capital gains basis.

II. Under Section 117 (j), unsevered citrus fruits which are disposed of as part and parcel of the sale of the land and trees, are "not . . . property held by the taxpayer primarily for sale to *customers* in the *ordinary* course of *his* trade or business."

Subsection 117(j) borrows the terminology which is pertinent here from subsection 117(a)(1). This subsection defines "capital assets", and excludes from that classification—

> ". . . property held by the taxpayer primarily for sale to *customers* in the *ordinary* course of his trade or business . . ."

The legislative history of this phraseology conclusively demonstrates the desire of the Congress to limit this

exclusion from "capital assets" and "property used in the trade or business" to its narrowest possible interpretation.

The quoted exclusion first appeared in the Revenue Act of 1924 (Section 208 (8)) with the emphasized words omitted. It was amended by the Revenue Act of 1934.

The capital gains and losses provisions of the Revenue Act of 1934 were substantially affected by two considerations:

(1) In the depression period capital losses were a much more important consideration than capital gains.

(2) The pressure for revenues in a depression period required that ordinary losses be limited to a minimum, and the effect of capital losses on revenues be likewise limited.

To some extent these considerations were brought into the Revenue Act of 1932 (Homer Hendricks, *Federal Income Tax: Capital Gains and Losses,* 49 Harv. Law Rev. 262, 263; *House Report No. 708, 72nd Congress, First Session, Cumulative Bulletin 1939-1, Part 2,* p. 465; *Senate Report No. 665 72nd Congress, First Session, Cumulative Bulletin 1939-1, Part 2,* pp. 503-504, 508-510). They are also involved in the Revenue Act of 1934, which severely limited the deductibility of all capital losses (*Hendricks,* supra, 262).(2). It was therefore considered

(2) "Congress was prompted to this action by the disclosure that several prominent financial leaders had paid no Federal income tax during 1930, 1931 and 1932, because their losses on sales of securities offset their very substantial income from other sources." *Thomas E. Wood,* 16 TC 213, 219-220. This situation had actually preceded the enactment of the 1932 Act but was still reverberating *(Cumulative Bulletin, 1939-1,* part 2, pp. 465-466; pp. 503-504, 508,510).

advisable to define "capital assets" as *broadly* as possible; and that Congressional intention is abundantly clear from the committee reports. The following statements are from those reports as reprinted in *Cumulative Bulletin 1939-1,* Part 2:

> "Subsection (117) (b) defines capital assets. It will be noted that the definition includes all property, except as specifically excluded".*)
> (p. 577, *House Report*).

> "... the definition of capital assets has been slightly revised to prevent tax avoidance by excluding from the category of a capital asset 'property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business', instead of merely 'property held by the taxpayer primarily for sale in the course of his trade or business'. (p. 595, *Senate Report*).

> "The Senate amendment confines the exclusion to property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, thus making it impossible to contend that a stock speculator trading on his own account is not subject to the provisions of section 117." (p. 632, *Conference Report*).

While times may have changed, the statute remains as it was in 1934. It was intended to then provide, and it now provides, the *broadest possible definition of capital assets.* This intention necessarily carries over into its counterpart in subsection 117(j).

Considering then the application of the statute to this factual situation, we are confronted with two questions:

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*) This is also the language of the Regulations. Section 29.117-1.

1. What was the *property* sold?

2. Does that property fit within the *exclusion* of the statute?

The property sold. As we have demonstrated in the first section of this brief, the property sold was *real property*—all of it.

This Court has never reviewed the "fragmentation" doctrine of the sale of an operating business entity, as expressed in *Williams vs. McGowan,* 152 F. 2d 570 (CA, 2). We do not think it essential to a decision for the petitioners in this case that it do so now. That case held that the sale of a going business was not the sale of a single piece of property for income tax purposes, but that the business must be comminuted into its fragments and these would be separately matched against the statutory definitions of Section 117. Judge Frank's strong dissenting opinion (at page 573) is persuasive that a different result is more in harmony with the intent of the taxing statute. After all, Section 117 does not eliminate transactions from taxation; it merely classifies transactions and then determines the manner in which they shall be taxed. It is difficult to apprehend that Congress really intended to tax the sale of shares in an incorporated business on one basis, and the sale of an unincorporated business on an entirely different basis; or, as the *Williams* case holds, that Congress intended to tax the sale of a partnership interest on one basis and the sale of the same entire business on another basis.

But in the instant case, the respondent desires, not only to do violence to logic, but to nature. Here, he argues, we must apply the fragmentation doctrine so as to split off from the asset, that part which cannot

exist without sustenance from the remainder of the asset, the trees and the land—the growing immature fruit. We feel that the application of metaphysical principles to the practical science of taxation should end well before this point is reached.

We have already referred to the analysis of Judge Huxman on this point in the *McCoy* case (192 F. 2d 486, 488, CA, 10). The opinion of Judge Strum in the *Owen* case (192 F. 2d 1006, 1009) demonstrates the same point:

> "The severance made by the Commissioner for tax purposes was purely an artificial one, which did not in fact occur. While on the trees and unsevered, the fruit was as much a capital asset as the trees and land. The fruit was as much a part of the trees as the leaves and branches."

Thus there was a single and entire property sold which cannot be logically, tangibly, physically or commercially "fragmented".(3) That property we have demonstrated to be *real property*. The respondent has never disputed in these cases that the taxpayers have never held for sale to customers in the ordinary course of their trade or business any real property. Thus, the sale cannot be within that exception to the application of subsection 117(j).

The analogy attempted by the Court of Appeals in the instant case (197 F. 2d at p. 57) while ingenious, is not apt. The ten-story cooperative apartment venture (an anomaly in real property law anyway) does not bear the physical and natural relationship to the department store that the growing fruit does to a tree. But

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(3) It is a well known fact, demonstrated by evidence in other cases, that—unlike some other fruits—a citrus fruit will not develop further after being severed from the tree. It can only reach maturity while a part of the tree.

if it did, there is a further egregious error in that court's opinion in its application of the statute to horticultural realities.

The Statutory Exclusion. A fruit tree is a unique production machine. It is a bundle of potential crops; and from that fact it derives all of its value. The potential crop which is presently visible on the tree is no different from those which will follow it, except that it is the potential which will first become farm produce. But it is *not* farm produce until, at the very earliest, it attains maturity on the tree. Cultivation may increase this year's potential; and fertilizing may increase the following year's potential (Tr. 123), perhaps to the detriment of some later potential (Tr. 123-124). It is this bundle of potential crops—including the visible evidence of that which will first become farm produce—which is sold when the tree is sold. There is no basis for distinguishing between any of the potential crops. If one is to be "fragmented" out of the tree, as being "*property* held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," then *all* must be (an obviously absurd result) for the only *property held* at the time of sale is the land and trees.

It is true that there are infrequent "sales" by some growers of potential crops prior to their maturity (e. g., Tr. 119, 122-123); but these involve the condition that the growing immature fruit stay on the tree under either the buyer's or seller's management until maturity (Tr. 123). Actually they are in the nature of payments in advance for the mature product if and when it develops, and including, in effect, an interest in the land and trees which permit that growth to maturity. Problems of "constructive severance" might arise. Whether such deviations from the normal practice might present

new questions for consideration is immaterial to a decision of this case. It is the *taxpayers'* trade or business which is the criterion; and in the instant case—as in the usual case—that business was limited to the production and sale of *ripe* citrus fruits, not of a mere potential crop which was in *and* a part of the citrus tree.

It is the character of the property as it is held at and preceding the time of the sale which is the statutory criterion. That is plainly the wording of the statute. Respondent would have the exclusion refer to property which if continued to be held by the taxpayer, could *ultimately* change in form and substance and become property held for sale to customers in the ordinary course of his trade or business. The courts have justifiably been disinclined to so distort the statute. *United States vs. Bennett,* 186 F. 2d 407, 410; *Owen vs. Commissioner,* 192 F. 2d 1006, 1009.

From this arises another comment concerning the opinion of the Court of Appeals in the instant case. That opinion reads into the statute a requirement that there must be an intention to sell the real property (including the immature crop growing on the trees) for more than six months before its actual sale. On this the court bases its major disagreement with the Fifth Circuit in the *Owen* case (192 F. 2d 1006; cited *Watson* case, 197 F. 2d 58-59).

To begin with, this is a misinterpretation of the opinion in the *Owen* case. The Fifth Circuit was considering the character of the *property* held for sale, not the intention of the owner concerning its ultimate disposition. Furthermore, the opinion of Chief Judge Denman in the instant case would require the exclusion in the statute to be rewritten in somewhat the following terms:

". . . real property used in the trade or business, which, for more than six months, the taxpayer has not intended to sell to customers in the ordinary course of his trade or business."

Quite naturally we prefer it as it is written and, as we think, the Court of Appeals for the Fifth Circuit properly interpreted it.

In *Irrgang vs. Fahs*, 94 F. Supp. 206, 211, the court there pointed out that a holding of the land and trees for more than six months was a holding of the entire property for that period, inasmuch as the growing citrus fruit was an integral part of it.

As we have pointed out, a tree is a production facility which harbors only a *potential* product up until the day the complete product is produced, severed and delivered. Particularly in the case of citrus fruits, which do not develop after severance, a potential can never be a reality until it has matured and is delivered by harvesting. The potential fruit as it appears on the tree before maturity is merely a part of the tree which develops into the ultimate product, mature fruit; and is no more held for sale to customers in the ordinary course of the citrus producing business than is the fertilizer, water, sunshine, labor and other items which are used by the tree in producing the final product, farm produce, ultimately resulting from the entire growing, transformation and development process. The tree itself is one of the raw materials from which the finished product is finally formed. No crop comes into being, as such, until it is harvested. Its existence as a crop is merely potential or "prospective" (Regulations 111, Section 29.23(e)-5), until it is saleable in the citrus producer's hands.

It is obvious, therefore, that during the entire growing process, there is a single asset in the tree. Any potential fruit developing on that tree is "as much a part of the tree as the leaves and branches", *Owen vs. Commissioner,* 192 F. 2d 1006, 1009. A distinction between crop and tree at that point is a purely artificial one.

With regard to the amendment to Section 117(j) by the Revenue Act of 1951, we shall comment but briefly. The Court of Appeals for the Tenth Circuit in the *McCoy* case, 192 F. 2d 486, 488-489, concluded that the Senate Committee Report makes it clear that the purpose of the amendment was to clarify existing law. The third paragraph of that report, although couched in inartistic language, certainly conveys that meaning. The Court of Appeals in the instant case points out that the report contains a statement that the provision will result in a revenue loss of $3,000,000 annually, and thus arrives at an opposite conclusion. Whether this revenue loss results from a comparison with existing law, or with some version which might have been suggested by the Treasury Department as more consonant with its views, is not clear. The Court of Appeals for the Fifth Circuit saw in the Act no interpretation of existing law (192 F. 2d at 1009, note 1), and except to the extent referred to in the *McCoy* case above, this seems a proper conclusion.

Summary

We respectfully suggest that the "fragmentation" doctrine, if approved at all by this Court, be stopped at some point far short of a conflict with the laws of nature. To carry it to the length of requiring the separation into two "properties" of a distinct natural and physically inseparable unit of trees and growing fruit crops seems absurd.(4)

Nor does there seem to be any justification for determining that a citrus fruit grower who had never sold anything but ripe fruit, held non-edible and immature fruit *primarily* for sale to his *customers* in the ordinary course of his business.

Respectfully submitted,

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(4) We might suggest that respondent is the source of his own discomfort. Had not the inventorying of growing crops been prohibited by the Internal Revenue Bureau (see *Irrgang vs. Fahs,* 94 F. Supp. 206; 211), there would have been no difficulty in this case; except, of course, that that would have led to annual litigation over valuations with practically all farmers.